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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA, *Appellant*,

v.

FRANCHISE TAX BOARD, *Appellee*.

On Appeal From The Court Of Appeal Of The State Of California For The First Appellate District

BRIEF *AMICI CURIAE*

Amici Curiae:

ALLIED LYONS P.L.C.
BARCLAYS BANK P.L.C.
B.A.T INDUSTRIES P.L.C.
THE B.O.C. GROUP
THE BOWATER CORPORATION P.L.C.
CADBURY SCHWEPPES P.L.C.
THE CHARTERHOUSE GROUP P.L.C.
CHLORIDE GROUP LIMITED
FOSECO MINSEP LIMITED
IMPERIAL CHEMICAL INDUSTRIES P.L.C.
IMPERIAL GROUP P.L.C.
LLOYDS BANK P.L.C.
MIDLAND BANK P.L.C.
NATIONAL WESTMINSTER BANK LIMITED
RECKITT & COLMAN P.L.C.
REED INTERNATIONAL LIMITED
SEARS HOLDINGS LIMITED
UNILEVER P.L.C.
UNITARY TAX CAMPAIGN LIMITED

Attorneys:

LEE H. SPENCE
ROBERT L. ASH
KALER, WORSLEY, DANIEL & HOLLMAN
1200 Eighteenth Street, N.W.
Washington, D.C. 20036
(202) 331-9100

MARLOW W. COOK
(Counsel of Record)
F. EUGENE WIRWAHN
COOK, PURCELL, HANSEN & HENDERSON, CHARTERED
1015 Eighteenth Street, N.W.
Washington, D.C. 20006
(202) 659-1050

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QUESTIONS PRESENTED

1. Whether the application of California's franchise tax to include income of foreign corporations in a worldwide combined report creates a substantial risk of international multiple taxation in violation of the commerce clause of Article 1, Section 8 of the Constitution of the United States.

2. Whether the application of California's franchise tax on a worldwide combined basis is fundamentally flawed and does not produce a rational relationship between the income attributed to California and California values, in violation of the due process clause of the fourteenth amendment to the Constitution of the United States.

3. Whether the Constitutional infirmities of worldwide combined reporting are far more serious when the method is applied to foreign parent groups.

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BRIEF *AMICI CURIAE*

Allied Lyons p.l.c., Barclays Bank p.l.c., B.A.T Industries p.l.c., The B.O.C. Group, The Bowater Corporation p.l.c., Cadbury Schweppes p.l.c., The Charterhouse Group p.l.c., Chloride Group Limited, Foseco Minsep Limited, Imperial Chemical Industries p.l.c., Imperial Group p.l.c., Lloyds Bank p.l.c., Midland Bank p.l.c., National Westminster Bank Limited, Reckitt & Colman p.l.c., Reed International Limited, Sears Holdings Limited, Unilever p.l.c., and Unitary Tax Campaign Limited hereby submit this brief *amici curiae* in support of the appeal by Container Corporation of America ("Container") from a judgment of the Court of Appeal of the State of California for the First Appellate District, upholding the validity of the California franchise tax as construed to require worldwide combined reporting.[1]

[1] Appellant and Appellee have consented to the filing of this brief *amici curiae* in letters filed with the Clerk of the Court.

INTEREST OF *AMICI CURIAE*

The individual *amici curiae* ("*amici*") are parent corporations organized and existing under the laws of England. Together with their worldwide subsidiaries, they rank among the largest industrial and financial enterprises in the world. *Amici* have no permanent establishments in the United States and do not conduct business in the United States. However, they have subsidiary corporations which conduct business throughout the world, including United States subsidiaries with extensive business operations in the United States.

Amicus Unitary Tax Campaign Limited is an organization formed by more than 50 leading United Kingdom parent corporations for the express purpose of combatting worldwide combined reporting.

Amici have a direct and vital interest in opposing any attempt to impose formulary apportionment upon foreign corporations through worldwide combined reporting. By applying that method to the United States subsidiaries of foreign parent corporations, certain states of the United States reach, and tax, income which is earned by the foreign parents and their non-United States subsidiaries in their foreign operations and which is fully taxed abroad. The strength of the concern and resolve of *amici* in this matter is evidenced by their filing of a brief *amici curiae* in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al.*, prob. juris. noted, ___ U.S. ___, No. 81-349 (Oct. Term, 1982) ("*Chicago Bridge & Iron Company*"). Although both *Chicago Bridge & Iron Company* and the present case involve constitutional challenges to worldwide combination by United States parent corporations with foreign subsidiaries, the interests of *amici* may be significantly affected by the decisions of the Court in these cases.

The concerns expressed here by *amici* are but a small reflection of the unabated frustration and anger among foreign parent corporations and sovereign governments engendered by the worldwide combined reporting method. In the most recent expression of concern, on June 29, 1982 the Government of

Belgium, which now holds the presidency of the European Community, served a Note upon the United States Department of State reiterating the firm opposition of the ten member nations to this method of taxation:

> "Our Governments remain firmly convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory."

Foreign parent corporations have an even greater stake in this matter than do United States parent corporations. While for both United States and foreign parents the method suffers from the same fundamental flaw which produces a misattribution of foreign income to the states which employ it and thereby creates a substantial risk of multiple taxation, the constitutional infirmities are far more serious when the method is applied to foreign parent corporations. Accordingly, *amici* deem it essential that the Court consider their perspective in reaching its decision.

SUMMARY OF ARGUMENT

California's attempt to expand the unitary business principle to require worldwide combination of foreign corporations affiliated with a United States corporation violates the commerce clause and the due process clause. First, by including in the combination income of foreign corporations which is fully taxed in foreign countries, the method creates a substantial risk of international multiple taxation, in violation of the first principle applicable to state taxation of foreign commerce enunciated in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979). The facts of this case amply demonstrate that international multiple taxation is not only a substantial risk but a reality. Second, California's attempt to apply formulary apportionment on a worldwide basis is fundamentally flawed and constitutes taxation under a pretense. The requisite rational relationship between the income attributed to California and California values does not exist because the economies of foreign countries are not homogeneous with that of the

United States. Worldwide formulary apportionment is inherently arbitrary and produces such misattribution of foreign income to California as to violate due process. Finally, the constitutional infirmities of worldwide combined reporting are far more serious when the method is applied to foreign parent groups than when applied to United States parent groups.

ARGUMENT

I. Application of California's Franchise Tax to Include Income of Foreign Corporations in a Worldwide Combined Report Violates the Commerce Clause by Creating a Substantial Risk of International Multiple Taxation.

This Court has held that a state tax upon foreign commerce which "notwithstanding apportionment, creates a substantial risk of international multiple taxation," is unconstitutional under the commerce clause.[2] *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979) ("*Japan Line*"). "Even a slight overlapping of tax—a problem that might be deemed de minimis in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Id.* at 456. The reason for this special constitutional stricture is that in foreign commerce "true apportionment does not exist and cannot be policed by this Court at all." *Id.* at 455.

In their brief in *Chicago Bridge & Iron Company amici* maintain that by requiring income of foreign corporations

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[2] *Amici* respectfully submit that California's tax also contravenes the commerce clause by intruding upon federal prerogatives and preventing the United States from speaking with one voice in regulating the conduct of international commercial relations. California's worldwide apportionment method is irreconcilably at odds with the arm's length international separate accounting principle established by treaty and the Internal Revenue Code for federal income tax purposes. This contention is presented in their brief *amici curiae* in *Chicago Bridge & Iron Company*.

which is fully taxed abroad and not subject to federal tax to be included in the state tax base, the worldwide combined reporting method inexorably creates a substantial risk of international multiple taxation. Unless the apportionment factors applied to the worldwide income base eliminate the foreign income, there will be a resulting misattribution of such income to the taxing state; multiple taxation will occur whenever the foreign corporation is more profitable in relation to its apportionment factors than is the United States affiliate with which it is combined. *Amici* respectfully request the Court to give full consideration to the commerce clause arguments set forth in that brief in connection with this case, for the multiple tax risk and the resulting discrimination against foreign commerce is the primary constitutional defect of worldwide combination.

The record in the instant case amply demonstrates that international multiple taxation is not only a substantial risk but a reality. Container has established that the income of its foreign subsidiaries, determined on the basis of the internationally accepted arm's length separate accounting standard, was fully taxed for the years in question in the foreign countries in which those subsidiaries operate.[3] Container has likewise shown that the application of California's worldwide apportionment, if sustained, would result in the attribution to California of large amounts of the fully taxed foreign income of those subsidiaries, and consequently that California would also levy a tax on that foreign income. Specifically, for the years in question California attempts to tax over $1,200,000 of income that was also taxed by the domiciles of Container's foreign subsidiaries.[4] Such international double taxation is unconstitutional under the commerce clause.

The risk of international multiple taxation would be present even if formulary apportionment on a worldwide basis were

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[3] (J.A., Stip. ¶ 140 and Exhibit A thereto). All references to "J.A." are to the separately bound Joint Appendix.

[4] (J.A., Exhibit A to Stip.).

not fundamentally flawed. As *amici* discuss below in connection with the due process clause, a flaw exists which greatly increases that risk.

II. Application of California's Franchise Tax on a Worldwide Combined Basis is Fundamentally Flawed and Does Not Produce a Rational Relationship between the Income Attributed to California and California Values, in Violation of the Due Process Clause of the Fourteenth Amendment.

The due process clause of the fourteenth amendment to the Constitution imposes two requirements on a state before it can levy a tax on income generated in interstate commerce: "a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.' " *Exxon Corp.* v. *Wisconsin Department of Revenue*, 447 U.S. 207, 219-20 (1980) ("*Exxon*"), quoting *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-37 (1980) ("*Mobil*"); *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753 (1967); *Norfolk & Western R. Co.* v. *State Tax Commission*, 390 U.S. 317 (1968) ("*Norfolk & Western*").

As a threshold principle, a state has nexus to tax a corporation "if the corporation avails itself of the 'substantial privilege of carrying on business within the State.' " *Mobil*, 445 U.S. at 437, quoting *Wisconsin* v. *J. C. Penney Co.*, 311 U.S. 435, 444-45 (1940). California obviously has the requisite nexus to tax Container.[5]

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[5] The Court has not yet considered whether state nexus as to one corporation is sufficient to permit the state to ignore separate corporate existence and to require affiliated United States or foreign corporations conducting a unitary business with it to be included in a combined report. This issue has been raised and briefed by the appellant in *Chicago Bridge & Iron Company*.

In order for a state to tax a corporation engaged in interstate commerce on an *apportioned* basis, however, there must be a close functional relationship between the in-state activities and the income from interstate commerce which the state attempts to tax. "The 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary business principle.' " *Exxon*, 447 U.S. at 223, quoting *Mobil*, 445 U.S. at 439. Thus, the Court has recently held that a non-domiciliary state whose only contact with a corporation is the conduct of a unitary business within and without the state may tax a fair share of the income generated by the business, regardless of the geographic source of the income (*Exxon* and *Mobil*), but it may not tax income which is not derived from the unitary business operation. *ASARCO Inc.* v. *Idaho State Tax Comm'n.*, ____ U.S. ____, 50 U.S.L.W. 4962 (1982) ("*ASARCO*"); *F.W. Woolworth Co.* v. *Taxation and Rev. Dept. of New Mexico*, ____ U.S. ____, 50 U.S.L.W. 4957 (1982) ("*Woolworth*"). Accordingly, if Container is found not to be unitary with its foreign subsidiaries, worldwide combination would be prohibited by the "linchpin" standard.[6]

However, establishing the existence of a unitary business does not end the due process analysis, but merely lays the necessary foundation for the taxation of a reasonable share of income by a state in which that business is conducted. It is then necessary under the second prong of the due process test to consider whether the method used by the state to determine its share of that income is calculated to, and does in fact, produce a fair result.

"It is fundamental that a State has no power to impose a tax on income earned outside of the State." *Mobil*, 445 U.S. at 451 (Mr. Justice Stevens, dissenting). The due process clause pro-

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[6] *Amici* express no view as to whether Container and its subsidiaries are engaged in a unitary business.

hibits extraterritorial taxation whether such taxation results from apportionment or otherwise:

> "A State will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the peculiarities of a given enterprise, to 'project the taxing power of the state plainly beyond its borders.' *Nashville C. & St. L.R. Co.* v. *Browning*, 310 U.S. 362, 365 (1940). Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State."

Norfolk & Western, 390 U.S. at 325.

Due process does not require state income to be computed with mathematical precision, but only so as to obtain a "rough approximation" of the income that is "reasonably related to the activities conducted within the taxing state." *Exxon*, 447 U.S. at 223; *Moorman Manufacturing Co.* v. *Bair*, 437 U.S. 267, 273 (1978) ("*Moorman*"). However, a state tax which is "out of all appropriate proportion to the business transacted by the appellant in that state" will not satisfy the requirement of a rational relationship. *Hans Rees' Sons* v. *North Carolina*, 283 U.S. 123, 135 (1931). In such a case the income attributed to the state is "in no just sense attributable to transactions within" the state. *Id.* at 134. "[N]either does the Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most situations, may produce a tolerable product." *Norfolk & Western*, 390 U.S. at 327. A method of apportionment which is "inherently arbitrary" or which can be shown to have "produced an unreasonable result," will not satisfy due process. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920). Such a method will be correctly perceived by the Court as "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation." *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271, 283 (1924) ("*Bass, Ratcliff*").

For corporations operating in *interstate* commerce, it has long been established that the income approximations may be derived from formulas that rationally apportion the entire net

income of the unitary business conducted by the corporation. *Exxon*, 447 U.S. at 219; *Mobil*, 445 U.S.at 436; *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450 (1959). Moreover, the Court has afforded the states wide latitude in the factors to be included in the formulary apportionment. *Moorman*. Nonetheless, states are not free under the due process clause to impose an irrational apportionment.

Formulary apportionment was originated and nurtured in the United States as a rough but expedient method of dividing the total profits of a corporation engaged in a unitary business among the various states in which it operates. The three-factor formula employed by California has been generally accepted as a fair method of achieving this division, and its widespread use among the states has been motivated by a desire for uniformity.

Formulary apportionment is predicated upon the rational premise that one dollar of property, payroll or sales expended in one state will generate roughly the same amount of income as one dollar expended comparably in another state. The Court has implicitly acknowledged this premise in *Butler Brothers* v. *McColgan*, 315 U.S. 501 (1942), as follows:

> "We cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors may properly be deemed to reflect 'the relative contribution of the activities in the various states to the production of the total unitary income,' so as to allocate to California its just proportion of the profits earned by appellant from this unitary business." *Id.* at 509.

When the formula is applied to operations within the United States, where productivity, wage rates, costs of capital, gross profit margins, and returns on similar investments are reasonably homogeneous, and the currency is the same, it will result in attributing to each state in which the corporation operates at least a "rough approximation" of the income related to its activities in that state, as required by the due process clause. *Amici* are familiar with the application of this method to appor-

tion the income of their United States subsidiaries among the states in which they operate and take no exception to it.

However, a small number of states, led by California, have attempted to apply formulary apportionment on a worldwide basis.[7] *Amici* submit that this attempt must fail, for the rational relationship mandated by the due process clause is lacking. While apportionment "may produce a tolerable product" in a United States domestic setting, when applied internationally it produces an inherently distorted result which cannot satisfy even the broad latitude of a "rough approximation." The Court noted an analogous problem regarding the apportionment of railroad rolling stock for property tax purposes in *Norfolk & Western*, 390 U.S. at 329 (quoting Mr. Justice Holmes' statement in *Fargo* v. *Hart*, 193 U.S. 490, 499-500 (1904)):

> "So long as it fairly may be assumed that the different parts of a line are about equal in value a division by mileage is justifiable. But it is recognized in the cases that if for instance a railroad company had terminals in one state

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[7] The Court has not yet considered the validity of formulary apportionment of the income of foreign corporations not operating in the United States. State income tax apportionment of foreign source income has been challenged on due process grounds in four cases—*Bass, Ratcliff; Mobil; ASARCO;* and *Woolworth*. *Bass, Ratcliff* involved a single foreign corporation operating in the United States and England. In that case the taxpayer made no showing that the apportionment applied by New York resulted in a misattribution of foreign income and, in any event, the amount of tax in question, $826.14, was de minimis. While this Court's decision in *Mobil* implies that foreign income may not enjoy an absolute immunity from a fair apportionment under the due process clause, Mobil had "disclaimed any dispute with the accuracy or fairness of Vermont's apportionment formula." *Mobil*, 445 U.S. at 434. The inherent unfairness of the apportionment of worldwide income under California's combined reporting method is precisely the issue presented by the instant case. Finally, in *ASARCO* and *Woolworth* the Court did not reach the issue of the propriety of the state apportionment of dividends because the foreign subsidiaries were found not to be unitary with their United States parents.

> equal in value to all the rest of the line through another, the latter State could not make use of the unity of the road to equalize the value of every mile. That would be taxing property outside of the State under a pretense."

The situation with worldwide combined reporting is even more serious. There cannot be even a pretense that worldwide formulary apportionment properly reflects relative values and produces an appropriate result in the "usual" case. Distortions will not be confined to exceptional situations but must be the anticipated result of applying this method to widely disparate economies.

Apportionment on a worldwide combined basis is fundamentally flawed. In a multinational context, the assumption of comparable economic conditions that underlies the rationality of formulary apportionment in the United States is simply not valid. Worldwide economic conditions are much more diverse than conditions within the United States. There are wide ranges in wage rates and productivity of labor in different areas of the world; the costs of property and equipment vary substantially; accounting methods and currencies are different; conversion rates fluctuate; and rates of return on investment vary widely. An apportionment of total worldwide income that does not account for these differences cannot rationally approximate the fair share of business income generated by worldwide activities that relates to the corporate activities conducted within a particular state.

The record in this case includes testimony showing that the rates of return on investment in many foreign countries are expected to be, and are in fact, substantially higher than in the United States. Particularly in developing countries, political and commercial risks require companies to realize higher rates of return on operations than are realized on United States investments. Lower foreign wage rates and property values and larger gross profit margins account for these higher returns and create an inherent bias in formulary apportionment in favor of the states which require worldwide combination.

International disparities in wage rates are broad, and the United States tends to have higher rates.[8] These disparities have a compounded distorting effect in the three-factor apportionment formula. First, lower labor costs abroad tend to increase the net profit included in the worldwide income base which is apportioned by the three-factor formula. Second, the relatively higher United States costs produce a payroll factor which is biased towards the United States. The product of worldwide combination is a *reversal* of the true profit allocations. Manifestly, this is taxation of income "under a pretense" of worldwide factor comparability which simply does not exist.

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[8] In addition to comparable studies which *amici* understand will be cited in Appellant's brief, the broad pay rate disparities around the world are illustrated by the results of a study completed in April 1982 by the United States Department of Labor, Bureau of Labor Statistics, entitled "Hourly Compensation Costs for Production Workers in Manufacturing." The study compares hourly compensation costs for production workers in manufacturing industries in selected countries. While a few of the major industrialized countries show costs comparable to or in excess of the United States index, most are lower, and the results for developing countries are uniformly and substantially lower. The following table, drawn from that study, shows comparative hourly compensation for various countries using an index of 100 for the United States:

	1978	*1979*	*1980 (Preliminary Estimates)*	*1981 (Provisional Estimates)*
United States	100	100	100	100
Canada	93	90	90	89
Brazil	20	19	17	19
Mexico	24	26	30	33
Venezuela	30	30	39	—
Australia	73	71	73	73
Hong Kong	14	14	13	13
Israel	31	36	38	39
Japan	67	60	56	56
Korea	10	13	11	11
New Zealand	48	50	50	49
Singapore	11	12	12	—
Taiwan	10	11	13	14
Austria	75	79	79	63

The record in this case demonstrates the distorting effect of worldwide formulary apportionment. During the years involved (1963-1965), the average rate of return on operations of Container's foreign subsidiaries was 17.2%, while Container's rate of return from United States operations was 13.1%. Each dollar of net operating profit of the foreign subsidiaries required $7.05 of sales, $4.62 of tangible property and $1.05 of payroll. Over the same period, each dollar of net operating profit of Container's United States operations required $10.65 of sales, $4.83 of tangible property and $3.34 of payroll.[9] By including the income derived from the more profitable operations of the foreign subsidiaries in the base to be apportioned and mechanically applying the apportionment formula on a worldwide basis, the Franchise Tax Board was able to generate over $1,200,000 in additional California income.

Container has gone far beyond the efforts to show extraterritorial taxation based upon internal separate accounting which the Court found wanting in *Exxon*. It has demonstrated

	1978	*1979*	*1980 (Preliminary Estimates)*	*1981 (Provisional Estimates)*
Belgium	125	132	132	101
Denmark	106	111	104	82
Finland	69	81	82	74
France	79	87	92	75
Germany	116	124	123	95
Greece	28	31	31	28
Ireland	48	54	60	50
Italy	73	79	83	69
Luxembourg	118	121	118	—
Netherlands	120	126	122	93
Norway	114	111	113	95
Portugal	20	19	20	—
Spain	46	59	59	51
Sweden	116	125	125	107
Switzerland	116	117	112	91
Turkey	13	12	—	—
United Kingdom	52	61	74	67

[9] (Statistics derived from Sch. VI and Exhibit A to Stip., J.A.).

by "clear and cogent evidence": (1) the true profits of its foreign subsidiaries, (2) the inherent bias in worldwide combined reporting towards misallocation of foreign income to the United States, and (3) the precise manner in which that bias produces a distorted result in this case. Due process does not permit California to tax the foreign income which it claims here.

III. The Constitutional Infirmities of Worldwide Combined Reporting are Far More Serious when the Method is Applied to Foreign Parent Groups.

As this case amply demonstrates, combined reporting may not be constitutionally applied to foreign members of *any* corporate group. Nevertheless, application of the method to foreign parent corporations and their foreign affiliates raises serious concerns beyond those applicable to United States parent groups. The inherent bias of worldwide combined reporting creates even more unconscionable results in that situation. In the case of United States parent corporations, the distortion may produce a tax on foreign income which has not been repatriated through dividends. In the case of a United States subsidiary of a foreign parent, the foreign income reached by this method not only has no current relationship to United States operations but is not even under the control of the United States subsidiary whose nexus with the state provides the basis for taxation.

Worldwide combined reporting also imposes extraordinary and often impossible compliance burdens upon foreign parent groups. The method presumes a ready availability of financial records based upon United States tax principles. For United States parent groups, this may be a reasonable assumption. Few, if any, foreign parent corporations maintain financial accounting records in that form, but quite naturally adhere to the particular financial accounting requirements of their home countries. In many instances the task of converting to suit the state tax authorities is simply impossible. In others, foreign secrecy laws preclude disclosure of the information to state tax authorities. Faced with these practical difficulties, such au-

thorities frequently resort to estimates and approximations of both the apportionment factors and the income to be apportioned. The burden is vastly increased by the fact that foreign currencies must be translated into dollars in order to compute the income and apportionment factors. As *amici* state in their brief in *Chicago Bridge & Iron Company*, these are not merely problems of inconvenience. The rational relationship is lacking because the method simply *cannot* be applied properly to foreign parent groups.

Further, the unique status of foreign parent corporations under income tax treaties and treaties of friendship, commerce and navigation, coupled with the natural solicitude of foreign nations towards protecting their domiciliaries from excessive tax intrusions by the states of the United States, affords them an international legal status which is different from that of foreign subsidiaries of United States parent corporations.

CONCLUSION

Container has exposed worldwide combination for what it is—taxation "under a pretense"—"an effort to reach profits earned elsewhere under the guise of legitimate taxation." Even if the method did not have a fundamental flaw resulting in an inherent bias in favor of the taxing state, the substantial risk of international multiple taxation which necessarily arises from the apportionment of foreign income of foreign corporations violates the commerce clause. A "reasonable approximation," even if achievable, will not suffice in the international arena where "even a slight overlapping of tax" risks multiple taxation. The inherent bias demonstrated by the record in this case both exacerbates that risk and destroys the pretense that the worldwide combined reporting method has "reached, and was meant to reach, only the profits earned within the state." *Underwood Typewriter Co.* v. *Chamberlain*, *supra*, 254 U.S. at 121. Therefore, it fails to satisfy the requirements of due process as well.

For these reasons, the decision of the court below should be reversed. Should the Court find in this case that the application

of worldwide combined reporting to a United States parent corporation does not violate constitutional principles, *amici* ask that the Court expressly limit its opinion so as not to foreclose foreign parent corporations from demonstrating the constitutional infirmities of this method of taxation in other cases.

Respectfully submitted,

MARLOW W. COOK
(Counsel of Record)
F. EUGENE WIRWAHN
COOK, PURCELL, HANSEN & HENDERSON, CHARTERED
1015 Eighteenth Street, N.W.
Washington, D.C. 20006
(202) 659-1050

LEE H. SPENCE
ROBERT L. ASH
KALER, WORSLEY, DANIEL & HOLLMAN
1200 Eighteenth Street, N.W.
Washington, D.C. 20036
(202) 331-9100

Attorneys for *Amici Curiae:*

ALLIED LYONS P.L.C.
BARCLAYS BANK P.L.C.
B.A.T INDUSTRIES P.L.C.
THE B.O.C. GROUP
THE BOWATER CORPORATION P.L.C.
CADBURY SCHWEPPES P.L.C.
THE CHARTERHOUSE GROUP P.L.C.
CHLORIDE GROUP LIMITED
FOSECO MINSEP LIMITED
IMPERIAL CHEMICAL INDUSTRIES P.L.C.
IMPERIAL GROUP P.L.C.
LLOYDS BANK P.L.C.
MIDLAND BANK P.L.C.
NATIONAL WESTMINSTER BANK LIMITED
RECKITT & COLMAN P.L.C.
REED INTERNATIONAL LIMITED
SEARS HOLDINGS LIMITED
UNILEVER P.L.C.
UNITARY TAX CAMPAIGN LIMITED